

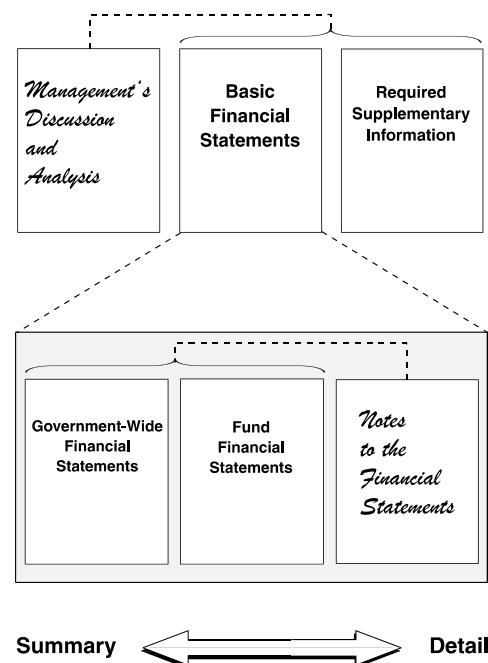
MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the City of Muskegon's annual financial report presents our discussion and analysis of the City's financial performance during the fiscal year ended December 31, 2003. Please read it in conjunction with the City's financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

- The City's total combined net assets were \$86,200,845 at December 31, 2003, an increase of \$10,570,908 (14.0%) over the prior year. Most of this increase is attributable to major street construction activities undertaken during the year. Of the total net assets, \$19,774,573 was unrestricted and may be used to meet the City's ongoing obligations to citizens and creditors.
- During the year, the City's total expenses for both governmental and business-type activities were \$38,489,639, a slight increase of \$220,634 (0.5%) over 2002. Of the total expenses for 2003:
 - \$13,380,231 (35%) was paid through direct charges (such as water fees) to benefiting parties;
 - \$16,364,857 (43%) was paid by grants and contributions, primarily from the state and federal governments; and
 - The remaining portion was paid from state shared revenues, local income and property taxes, and other locally generated revenues.
- The City's general fund reported a fund balance of \$2,431,418, a decrease of \$376,578 from the prior year. The City also maintained a budget stabilization (or "rainy day") fund that reported a fund balance of \$1.5 million at December 31, 2003, a decrease of \$500,000 from 2002.
- The City issued \$1.575 million in capital improvement bonds during fiscal year 2003 to finance citywide sidewalk improvements.

Figure A-1, Required Components of the City's Annual Financial Report



OVERVIEW OF THE FINANCIAL STATEMENTS

This annual report consists of three parts—*management's discussion and analysis* (this section), the *basic financial statements*, and *required supplementary information*. The basic financial statements include two kinds of statements that present different views of the City:

- The first two statements are *government-wide financial statements* that provide both *long-term* and *short-term* information about the City's overall financial status.
- The remaining statements are *fund financial statements* that focus on *individual parts* of the government, reporting individual City operations in greater detail than the government-wide statements.
 - *The governmental funds* statements tell how *general government* services were financed in the *short-term* as well as what remains available for future spending.
 - *Proprietary fund* statements offer *short- and long-term* financial information about activities the City operates *like private businesses*.
 - *Fiduciary fund* statements provide information about the financial relationships in which the City acts solely as a *trustee or agent* for the benefit of others, to whom the resources in question belong.

The financial statements also include detailed notes that explain some of the information in the financial statements and provide additional data. The statements are followed by a section of *required supplementary information* that further explains and supports the information in the financial statements. Figure A-1 shows how the required parts of this annual report are arranged and related to one another.

Figure A-2 summarizes the major features of the City's financial statements, including the portion of the City government they cover and the types of information they contain. The remainder of this overview section of management's discussion and analysis explains the structure and contents of each of the statements.

Figure A-2. Major Features of the City's Government-Wide and Fund Financial Statements

Type of Statements	Fund Statements			
	Government-Wide	Governmental Funds	Proprietary Funds	Fiduciary Funds
Scope	Entire City government (except fiduciary funds) and the City's component units	The activities of the City that are not proprietary or fiduciary	Activities the City operates similar to private businesses.	Instances in which the City is the trustee or agent for someone else's resources
Required financial statements	• Statement of net assets	• Balance sheet	• Statement of net assets	• Statement of fiduciary net assets
	• Statement of activities	• Statement of revenues, expenditures & changes in fund balances	• Statement of revenues, expenses and changes in fund net assets • Statement of cash flows	• Statement of changes in fiduciary net assets
Accounting basis and measurement focus	Accrual accounting and economic resources focus	Modified accrual accounting and current financial resources focus	Accrual accounting and economic resources focus	Accrual accounting and economic resources focus
Type of asset/liability information	All assets and liabilities, both financial and capital, short-term and long-term	Only assets expected to be used up and liabilities that come due during the year or soon thereafter; no capital assets included	All assets and liabilities, both financial and capital, and short-term and long-term	All assets and liabilities, both short-term and long-term; the City's funds do not currently contain capital assets, although they can
Type of inflow/outflow information	All revenues and expenses during year, regardless of when cash is received or paid	Revenues for which cash is received during or soon after the end of the year; expenditures when goods or services have been received and payment is due during the year or soon thereafter	All revenues and expenses during year, regardless of when cash is received or paid	All revenues and expenses during year, regardless of when cash is received or paid

Government-Wide Statements

The government-wide statements report information about the City as a whole using accounting methods similar to those used by private-sector companies. The statement of net assets includes all of the government's assets and liabilities. All of the current year's revenues and expenses are accounted for in the statement of activities regardless of when cash is received or paid.

The two government-wide statements report the City's net assets and how they have changed. Net assets—the difference between the City's assets and liabilities—is one way to measure the City's overall financial health or *position*. Over time, increases or decreases in the City's net assets are an indicator of whether its financial health is improving or deteriorating, respectively. However, to assess the overall health of the City, one needs to consider additional nonfinancial factors such as changes in the City's tax base.

The government-wide financial statements include not only the City of Muskegon itself (known as the *primary government*), but also legally separate *component units* for which the City is financially accountable. Financial information for these component units is reported separately from the financial information presented for the primary government itself.

The government-wide financial statements of the City include the *governmental activities*. Most of the City's basic services are included here, such as general government, public safety, highways and streets, sanitation, economic development, parks and recreation, and interest on long-term debt. Income taxes, property taxes and revenues from the State of Michigan finance most of these activities. The government-wide financial statements can be found beginning on page 32 of this report.

Fund Financial Statements

The fund financial statements beginning on page 34 provide more detailed information about the City's major *funds*—not the City as a whole. Funds are accounting devices that the City uses to keep track of specific sources of funding and spending for particular purposes.

- Some funds are required by State law or other legal requirements.
- The City Commission establishes other funds to control and manage money for particular purposes or to show that it is properly using certain taxes and grants.

The City has the following kinds of funds:

- *Governmental funds*—Most of the City's basic services are included in governmental funds, which focus on (1) how *cash and other financial assets* that can readily be converted to cash flow in and out and (2) the balances left at year-end that are available for spending. Consequently, the governmental fund statements provide a detailed *short-term* view that helps the user determine

whether there are more or fewer financial resources that can be spent in the near future to finance the City's programs. Because this information does not encompass the additional long-term focus of the government-wide statements, we provide additional information on the subsequent page of the governmental funds statements that explain the relationship (or differences) between them.

- *Proprietary funds*—Services for which the City charges customers a fee are generally reported in proprietary funds. Proprietary funds, like the government-wide statements, provide both long-term and short-term financial information.
- We use *internal service funds* to report activities that provide supplies and services for the City's other programs and activities.
- *Fiduciary funds*—The City is the trustee, or *fiduciary*, for certain funds. It is also responsible for other assets that—because of a trust arrangement—can be used only for the trust beneficiaries. The City is responsible for ensuring that the assets reported in these funds are used for their intended purposes. All of the City's fiduciary activities are reported in a separate statement of fiduciary net assets and a statement of changes in fiduciary net assets. We exclude these activities from the City's government-wide financial statements because the City cannot use these assets to finance its operations.
- *Component units* – Finally, the City of Muskegon's Comprehensive Annual Financial report includes two component units: Downtown Development Authority (DDA) and Local Development Finance Authority (LDFA), which contains three sub-districts. Component units are separate legal entities for which the City of Muskegon has some level of financial accountability. The component units of the City exist primarily for the issuance and repayment of debt to finance projects in specific areas of the City. Accordingly, they are discussed below under the *Capital Assets and Debt Administration* heading.

FINANCIAL ANALYSIS OF THE CITY AS A WHOLE

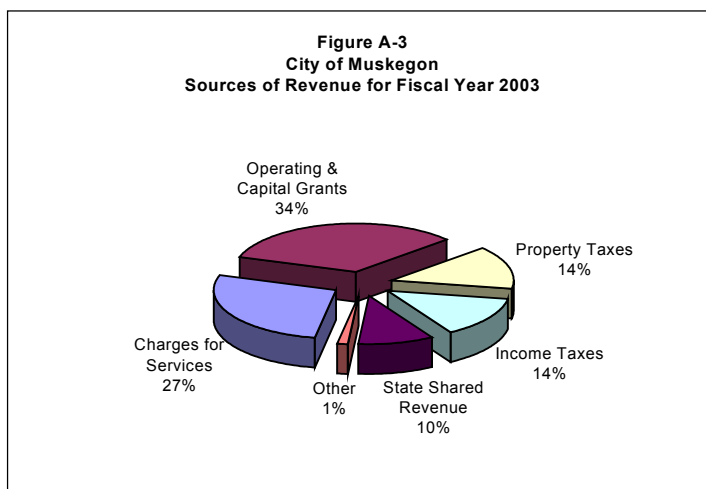
Net assets. The Statement of Net Assets provides an overview of the City's assets, liabilities and net assets. Over time this can provide a good indicator of the City's fiscal health. A summary of the City's net assets follows:

City's Net Assets
(In thousands of dollars)

	Governmental Activities		Business-Type Activities		Total		Total Percentage Change
	2003	2002	2003	2002	2003	2002	2003-2002
Current and other assets	\$32,654	\$29,530	\$13,539	\$15,059	\$46,193	\$44,589	3.6%
Capital assets	39,203	30,604	41,352	40,942	80,555	71,546	12.6%
Total Assets	71,857	60,134	54,891	56,001	126,748	116,135	9.1%
Long-term liabilities	8,615	8,231	15,328	16,881	23,943	25,112	-4.7%
Other liabilities	16,161	14,970	444	423	16,605	15,393	7.9%
Total Liabilities	24,776	23,201	15,772	17,304	40,548	40,505	0.1%
Net Assets							
Invested in capital assets, net of related debt	32,120	23,793	27,809	26,226	59,929	50,019	19.8%
Restricted	5,674	4,462	822	823	6,496	5,285	22.9%
Unrestricted	9,287	8,678	10,488	11,648	19,775	20,326	-2.7%
Total Net Assets	\$47,081	\$36,933	\$39,119	\$38,697	\$86,200	\$75,630	14.0%

The total net assets of the City were \$86,200,845 as of December 31, 2003. This represents an increase of \$10,570,908 over the prior year. This change is explained more fully below.

Changes in net assets. The City's total revenues were \$49,060,547. A significant portion (27%) of the City's revenue stream came from charges to users of specific services such as water or sewer (See Figure A-3). Another thirty-four percent came from various grants from the state and federal governments and twenty-eight percent was from local property and income taxes. The remainder was comprised of state-shared revenues (10%) and various other sources such as interest income.



The total cost of all City programs and services during 2003 was \$38,489,639. Seventy-eight percent of these costs were for governmental activities such as police and fire protection, streets, parks, and general administration. The remaining twenty-two percent represents business-type activities operated by the City, specifically, water, sewer and marina operations.

The difference between the City's total revenues and expenses (\$10,570,908) represents the increase in total net assets for 2003. The increase is primarily attributable to the receipt of large capital grants for street and other infrastructure improvements. The following table (*Changes in City's Net Assets*) further breaks down the change in total net assets into year-to-year changes in individual revenue and expense categories:

Changes in City's Net Assets (In thousands of dollars)							
	Governmental Activities		Business-Type Activities		Total		Total Percentage Change
	2003	2002	2003	2002	2003	2002	2003-2002
Program revenues							
Charges for services	\$4,917	\$4,506	\$8,463	\$8,261	\$13,380	\$12,767	4.8%
Operating grants and contributions	5,614	5,497	-	500	5,614	5,997	-6.4%
Capital grants and contributions	10,495	5,383	256	-	10,751	5,383	99.7%
General revenues							
Property taxes	7,029	7,176	-	-	7,029	7,176	-2.0%
Income taxes	6,645	6,877	-	-	6,645	6,877	-3.4%
State shared revenues	4,939	5,354	-	-	4,939	5,354	-7.8%
All other	719	1,069	(17)	105	702	1,174	-40.2%
Total revenues	40,358	35,862	8,702	8,866	49,060	44,728	9.7%
Governmental activities expenses							
Public representation	888	986	-	-	888	986	-9.9%
Administrative services	1,228	1,287	-	-	1,228	1,287	-4.6%
Financial services	1,843	1,855	-	-	1,843	1,855	-0.6%
Public safety	11,583	11,576	-	-	11,583	11,576	0.1%
Public works	2,947	2,830	-	-	2,947	2,830	4.1%
Leisure services	3,042	3,009	-	-	3,042	3,009	1.1%
Planning and economic development	3,371	4,015	-	-	3,371	4,015	-16.0%
Highways, streets and bridges	3,483	2,881	-	-	3,483	2,881	20.9%
General administration	1,601	1,750	-	-	1,601	1,750	-8.5%
Interest on long-term debt	224	308	-	-	224	308	-27.3%
Business-type activities expenses							
Water	-	-	4,538	4,038	4,538	4,038	12.4%
Sewer	-	-	3,416	3,441	3,416	3,441	-0.7%
Marina	-	-	326	293	326	293	11.3%
Total expenses	30,210	30,497	8,280	7,772	38,490	38,269	0.6%
Change in net assets	10,148	5,365	422	1,094	10,570	6,459	63.6%
Net assets at beginning of year	36,933	31,568	38,697	37,603	75,630	69,171	9.3%
Net assets at end of year	\$47,081	\$36,933	\$39,119	\$38,697	\$86,200	\$75,630	14.0%

Governmental Activities

The following table (*Net Cost of Selected City Functions*) presents the cost of each of the City's largest functions as well as each function's net cost (total cost less fees generated by the activities and related intergovernmental aid). The net cost reflects what was funded by local tax dollars and other general resources.

- The operational cost of all governmental activities during 2003 was \$30,209,680. This is a slight decrease from 2002 as the City continued to reduce costs in response to economic conditions and falling state-shared revenues.
- The net cost that City taxpayers paid for these activities through local taxes was \$13,674,101, or about 45% of the total.
- The remaining cost was paid by user charges to those who directly benefit from the programs or by state and federal grants and contributions.
- Revenues for highways and streets function exceeded program costs because the City's historic infrastructure or related depreciation costs are not yet recorded. GASB 34 requires that this information be reported by the year ending December 31, 2007. The City plans to include this information in the 2004 CAFR.

Net Cost of Selected City Functions
(in thousands of dollars)

	Total Cost of Services		% Change	Net Cost of Services		% Change
	2003	2002		2003	2002	
Governmental activities						
Public safety	\$11,583	\$11,576	0.1%	\$10,210	\$10,061	1.5%
Planning and economic development	3,371	4,015	-16.0%	(351)	363	-196.7%
Leisure services	3,042	3,009	1.1%	1,717	1,843	-6.8%
Highways and streets	3,483	2,881	20.9%	(9,220)	(4,773)	93.2%
Public works	2,947	2,830	4.1%	2,290	2,575	-11.1%
All other	5,784	6,186	-6.5%	4,538	5,042	-10.0%
Total governmental activities	\$30,210	\$30,497	-0.9%	\$9,184	\$15,111	-39.2%

Business-Type Activities

The financial goal of the City's business-type activities (i.e. water, sewer and marina operations) is to operate on a more or less "break-even" basis without making significant profit or needing general tax subsidies. For 2003 this goal was achieved with the City's total business-type activities realizing an overall increase in net assets of \$422,641. These funds were used to pay debt principal or invest in capital assets.

FINANCIAL ANALYSIS OF THE CITY'S FUNDS

The analysis of the City's major funds begins on page 34 of the CAFR report, following the government-wide statements. The fund financial statements provide detailed information about the major City funds, not the City as a whole. The City's major funds for 2003 were the general fund and the major and local street funds.

General Fund Budgetary Highlights

The general fund receives the most public attention since it is where local tax revenues are accounted for and where the most popular municipal services such as police, fire and parks are funded. The City reforecasts its general fund budget on a quarterly basis to take into account changing economic conditions and policy priorities. The quarterly budget reforecasts were particularly relevant in 2003 due to the turbulent state and national economies. A \$500,000 transfer from the City's rainy day fund was needed at year-end to offset revenue losses, particularly state shared revenues. The following table shows the general fund year-end fund balance for the last four years:

Year	Year-End Fund Balance	Year-to-Year % Change	Prior Year's Expenditures	Fund Balance as a % of Prior Year Expenditures (Policy Target = 10%)
2003	\$2,431,418	-13.4%	\$ 23,971,536	10.14%
2002	2,807,996	-11.2%	23,235,978	12.08%
2001	3,162,368	+7.1%	22,232,657	14.22%
2000	2,951,735	-	22,011,881	13.41%

Actual 2003 general fund expenditures were \$269,150 below original budget amount. Most of this variance occurred in the areas of salaries, benefits and other operating costs as the City continued to manage its way through a difficult economy.

General fund revenues in 2003 were \$305,302 less than originally budgeted:

- Most significantly, state shared revenues were \$611,441 under original budget due to faltering state sales tax collections and cutbacks by the state.
- As noted, a \$500,000 transfer from the budget stabilization fund was needed to help offset this revenue shortfall.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

At the end of 2003, the City and its component units had invested \$84,738,825 in a wide range of capital assets, including land, equipment, buildings, water and sewer lines, and vehicles. In addition the City reports infrastructure assets, including roads, bridges, sidewalks, and storm sewers acquired or improved since the start of 2002. In future years, the City will also include historical infrastructure asset investments made between 1980 and 2002. Note C of the notes to the basic financial statements provides detailed information on the City's capital asset investment.

The City's fiscal year 2004 capital budget anticipates spending \$24,340,556 for capital projects principally street and water system improvements. These improvements will be funded through grants, bond proceeds, and operating revenues. Accordingly, revenue bonds in the amount of \$13.9 million were issued in March 2004 to finance improvements to the City's water filtration plant.

Bond Ratings

The City's limited full faith and credit bonds (i.e. bonds guaranteed by the City's general taxing powers) presently carry a Standard & Poors rating of "A".

Long-Term Debt

At year-end the City had \$22,297,288 in bonds and notes outstanding as shown below. During 2003, new capital improvement bonds in the amount of \$1,575,000 were issued for the purpose of financing citywide sidewalk improvements. Additional information concerning the City's long-term debt is presented in Note D to the basic financial statements.

City's Long Term Debt (In thousands of dollars)							
	Governmental Activities		Business-Type Activities		Total		Total Percentage Change
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003-2002</u>
Bonds and loans payable	\$7,159	\$6,857	\$15,138	\$16,695	\$22,297	\$23,552	-5.3%
Long-term absences payable	<u>1,456</u>	<u>1,374</u>	<u>190</u>	<u>186</u>	<u>1,646</u>	<u>1,560</u>	5.5%
Total bonds & notes payable	\$8,615	\$8,231	\$15,328	\$16,881	\$23,943	\$25,112	-4.7%

In addition to the City's debt, component units such as the Downtown Development Authority (DDA) and Local Development Finance Authority (LDFA) had outstanding debt totaling \$9,386,403 at year-end as shown in the table below. During 2003, \$725,000 of series 1994 LDFA bonds with relatively high interest rates were called using available cash on hand. Debt issued by the component units is typically secured by the limited full faith and credit of the City and so is an important consideration in assessing the City's overall fiscal health. Additional information concerning component units' long-term debt is presented in Note D to the basic financial statements and is summarized as follows:

Component Unit Long Term Debt (In thousands of dollars)							
	Downtown Finance Authority		Local Development Finance Authority		Total		Total Percentage Change
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003-2002</u>
Bonds and loans payable	\$4,670	\$4,840	\$4,716	\$5,541	\$9,386	\$10,381	-9.6%

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

The City depends on five major sources of income to fund operations: local income taxes, local property taxes, state-shared revenues, state street funds, and water and sewer utility fees. Together, these five income sources accounted for \$26,801,831, or 82% of the City's 2003 non-grant revenues. Clearly, discussion of the City's financial outlook must center on these major income sources.

Local Income Tax

The City income tax was approved by voters in 1993 and now is the primary source of funding for police, fire, parks and other general operations. The tax rate is 1% on city residents and ½ of 1% on non-residents who work in the city. The income tax provides key advantages for an urban core city such as Muskegon. First, it allows the City to regionalize its tax structure by taxing non-residents who work here and use City services and by allowing the City to benefit from development occurring outside the City limits. A second major advantage is that it generates revenue from employees working at hospitals, government agencies, colleges and other institutions traditionally exempted from paying property taxes. This is particularly important for Muskegon since six of the ten largest income tax sources are such institutions. Income tax revenues declined from \$6,692,609 in 2002 to \$6,542,355 for 2003 (-2.2%) due to general economic

conditions. For 2004, the City is conservatively estimating income tax revenues at \$6,450,000. The following table shows the resident and non-resident composition of the income tax base:

Category	Number of Payers	2003 Amount Paid	Percent of Total	Average Amount Paid
City Resident	8,439	\$ 2,442,102	37%	\$ 289
Non-Resident	14,904	3,598,295	55%	241
Corporate	1,700	501,958	8%	295
Total	25,043	\$6,542,355	100%	\$ 261

Local Property Tax

The City's 2003 property tax millage consisted of 10 mills: 7 mills for general operations and 3 mills levied for sanitation. City charter authorizes a general operating millage up to 10 mills and state law permits a maximum sanitation millage of 3 mills. For 2004, the City's operating millage was adjusted to 7.5 mills while the sanitation millage was reduced to 2.5 mills. This change was made to reflect cost efficiencies in the sanitation program and also to forestall the possibility of future automatic millage rollbacks due assessment growth. Millage rates are applied to the taxable value of property in the City to arrive at the City's property tax levy. As shown below, taxable values have grown marginally over the last few years.

Year	Real	Personal	Total	Percent Change
2003	\$661,692,712	\$177,348,400	\$839,041,112	+1.6%
2002	638,624,250	187,393,600	826,017,850	+1.6%
2001	601,420,300	211,503,600	812,923,900	+12.3%
2000	543,897,900	180,164,900	724,062,800	-

State Shared Revenues

State shared sales tax revenues represent 21% of total general fund revenue and other financing sources. The City's state shared revenue allocation is made up of two approximately equal parts. The constitutional component is a fixed percentage of total state sales tax collections that cannot be reduced by the legislature. The statutory component is determined by a complex formula and is subject to adjustment through the State's budget process. Both constitutional and statutory components depend, of course, on overall state sales tax collections. Over the last several years, state shared revenues have fallen sharply due to the faltering economy and to executive order budget cuts in the statutory share. The most recent data available from the state indicates that the state shared revenues will fall short of the City's original 2004 budget estimate. The City is in the process of making budget adjustments to address this shortfall. State shared revenue received by the City in recent years is summarized below:

Year	State Shared Revenues	Percent Change
2004 *	\$4,700,000	-4.8%
2004 **	5,000,000	+1.2%
2003	4,938,861	-7.8%
2002	5,353,987	-6.9%
2001	5,748,523	-
* Current revised budget amount		
** Original budget amount		

Continued erosion of the state shared revenue component constitutes the single biggest threat to the stability of City finances at this time. Due to the local income tax, Muskegon is somewhat less dependent on this revenue source than most Michigan cities.

Street Funds

The State also returns to the City a share of gasoline tax revenues to help fund maintenance and construction of major and local streets in the City. These revenues have not suffered to the extent that general state sales tax revenues have:

Year	Street Revenues from State	Percent Change
2004*	\$3,314,260	+4.7%
2003	3,166,406	-1.7%
2002	3,220,625	+1.9%
2001	3,159,325	-
* Budgeted amount		

Water and Sewer Fees

From a government-wide entity perspective, combined water and sewer fees represent the City's largest income source totaling \$8,188,869 in 2003. Charges to customers are based on the amount of metered services used times rates periodically set by the City Commission. For 2004, it is anticipated that sewer rates will remain unchanged. Water rates were increased January 1, 2004 to help finance major improvements at the water filtration plant. Muskegon's water and sewer rates consistently rank among the lowest in the state.

CONTACTING THE CITY'S FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the City's finances and to demonstrate the City's accountability for the money it receives. If you have questions about this report, need additional financial information, or wish to obtain separate financial statements for the City's component units, contact the City's Finance Department at (231) 724-6713 or by e-mail (finance@shorelinecity.com).